IIEC Exhibit 5

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

ILLINOIS POWER COMPANY	:	
	:	
Proposed revisions to delivery service tariff sheets and other sheets	:	Docket No. 01-0432
	:	

Rebuttal Testimony of

Michael Gorman

On behalf of

Illinois Industrial Energy Consumers

November 2001
Project 7626

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

STATE OF ILLINOIS

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TABLE OF CONTENTS

Page

RESPONSE TO IP WITNESS DANIEL MORTLAND 2

RESPONSE TO IP WITNESS REBUTTAL TESTIMONY PAUL R. MOUL 4

RESPONSE TO ICC STAFF WITNESS ROCHELLE LANGFELDT 21

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	:	
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Rebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME FOR THE RECORD.

A My name is Michael Gorman.

Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY OFFERED TESTIMONY IN THIS PROCEEDING?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A I will respond to the rebuttal testimonies of Illinois Power Company (IP or Company) witnesses Daniel L. Mortland and Paul R. Moul. I will also respond to the rate of return recommendation of Illinois Commerce Commission (ICC or Commission) Staff witness Rochelle Langfeldt. My failure to respond to any positions taken by other witnesses' testimony should not be construed as an implied endorsement or acceptance of that position.

RESPONSE TO IP WITNESS DANIEL MORTLAND

Q ON PAGE 9 OF HIS REBUTTAL TESTIMONY, MR. MORTLAND MADE CERTAIN COMMENTS RELATED TO YOUR CONCLUSION THAT IP'S PROPOSED CAPITAL STRUCTURE, EXCLUDING TRANSITIONAL FUNDING INSTRUMENTS (TFIs), IS REASONABLE FOR RATEMAKING PURPOSES BECAUSE THE COMMON EQUITY RATIO WAS 45.4%. PLEASE SUMMARIZE MR. MORTLAND'S REBUTTAL TESTIMONY ON THIS ISSUE.

A Mr. Mortland offered two comments related to this testimony. Mr. Mortland's comments included the following:

1. Mr. Mortland couldn't tell whether or not the debt ratio medians listed in the credit reports included TFIs such as those included in IP's ratemaking capital structure in this proceeding. Mr. Mortland observes that IP's common equity ratio including TFIs is approximately 36%, which he believes is materially different than the published medians.
2. Mr. Mortland states that Standard & Poor's includes purchased power obligations as debt in its review of a utility's total leverage. He, therefore, implies that my review of IP's capital structure may not be complete.

Q SHOULD IP'S EQUITY AND DEBT RATIOS BE CALCULATED WITH TFIs WHEN COMPARING THE RATIOS TO CREDIT ANALYSTS' MEDIAN RATIOS?

A No. In IP's response to IIEC's Seventh Set of Data Requests, Item 111, which is attached as IIEC Exhibit 5, Schedule 1, Mr. Mortland acknowledged that credit rating agencies do not include the TFI instruments in assessing IP's debt leverage for credit rating purposes. I excluded TFIs in comparing IP's total debt ratio to credit rating analysts' median debt ratio benchmarks. This is a proper comparison because I calculated IP's debt ratios the same way IP told this Commission that credit analysts would measure its leverage. I then compared IP's credit rating debt ratio to median industry debt ratios calculated by credit analysts. This is a proper and an apples-to-apples comparison.

Q IS MR. MORTLAND CORRECT THAT CREDIT ANALYSTS INCLUDE PURCHASED POWER OBLIGATIONS IN THE CAPITAL STRUCTURE AS DEBT IN EVALUATING A UTILITY'S LEVERAGE.

A Not entirely. As shown in IIEC Exhibit 5, Schedule 1, Mr. Mortland modified his position by acknowledging that credit analysts do consider purchased power obligations as off-balance sheet debt obligations but only to the extent said contracts include fixed cost provisions. I agree with his modified position offered in the attached data response. However, even to the extent purchased power contracts have some form of fixed cost provisions, credit rating agencies do not necessarily assign full debt equivalents to the purchased power obligations. The purchased power debt equivalents depend on the structure of the purchased power contract and the requirements to pay for energy and/or capacity even when the supply resource isn't needed or available.

However, the debt equivalent of IP's off-balance sheet obligations, including purchased power obligations, is clearly listed by Standard and Poor's in its credit reports of IP and other utilities. Therefore, there is little need for Mr. Mortland or me to estimate if IP's contracts have debt equivalents, because credit reports will disclose this information. For example, IP's response to IIEC's First Set of Data Requests, Item 15, in it's Report on IP dated November 1998, Standard & Poor's concluded that IP had no off-balance sheet debt equivalent obligations and estimated IP's debt ratio with only on-balance sheet debt. In another data request concerning this issue, I asked Mr. Mortland to provide all credit rating reports he reviewed on IP issued in the last two years. He responded that he reviewed certain reports provided in response to IIEC's First Set of Data Requests, Item 21, but couldn't recall if he has reviewed other reports (Response to IIEC Seventh Set of Data Requests Item 110). The data provided in response to Item 21 included summary credit opinions and rating updates, but it did not include complete credit reports on IP like the 1998 report provided in response to Item 15. Therefore, Mr. Mortland has not provided any support for his speculation that IP's purchased power obligations represent debt equivalents.

My conclusion that IP's capital structure is reasonable for a distribution utility based on a comparison of IP's debt ratio, excluding TFIs, to credit rating utility median total debt ratios is reasonable.

Q IS THERE A COST OF SERVICE IMPACT RELATED TO YOUR DISAGREEMENT WITH MR. MORTLAND?

A No, Mr. Mortland has not proposed to alter his original capital structure recommendation. This is a policy issue related to IP's obligation to minimize its cost of capital by balancing its capital structure. Credit analysts medians are a good benchmark to use to test the reasonableness of IP's capital structure. Maintaining a reasonable capital structure will support the Company's financial integrity and preserve its credit quality. These are primary objectives in estimating a fair rate of return. Hence, comparing IP's capital structure to the capital structures for distribution utilities with similar bond ratings is an appropriate benchmark upon which to judge the reasonableness of IP's capital structure.

RESPONSE TO IP WITNESS REBUTTAL TESTIMONY PAUL R. MOUL

Q PLEASE BRIEFLY SUMMARIZE MR. MOUL'S REBUTTAL TESTIMONY TO YOU.

A Mr. Moul's comments concern: (1) the appropriateness of the proxy group from which I estimated IP's return on common equity, (2) discounted cash flow analysis (3) non-constant growth discounted cash flow analysis, (4) risk premium, and (5) CAPM analyses. For the reasons set forth below, Mr. Moul's contentions are baseless and should be rejected. IP's cost of common equity is no higher than 11.1%.

Q PLEASE SUMMARIZE MR. MOUL'S ARGUMENTS CONCERNING THE APPROPRIATENESS OF YOUR PROXY GROUP.

A Mr. Moul contends that my proxy group is unreasonable for principally three factors:

1. The proxy group should consist of utility companies that are geographically close in proximity to the subject company.
2. I used a single proxy group where I should have used two proxy groups as Mr. Moul and Staff did in this proceeding.
3. The common equity ratios for my proxy group are higher than the common equity ratio for IP when TFIs are included in the capital structure. He concludes, that because IP's financial risk is higher, it should be awarded a higher rate of return.

Q IS MR. MOUL'S CONTENTION THAT A PROXY GROUP SHOULD BE SELECTED USING UTILITY COMPANIES WHICH ARE GEOGRAPHICALLY CLOSE IN PROXIMITY TO THE SUBJECT COMPANY REASONABLE?

A No. Mr. Moul bases this contention on his interpretation of the Bluefield rate of return standard. Mr. Moul's interpretation of this standard is limited, and doesn't appear to reflect the full rate of return standards enunciated in Bluefield and Hope, as I described in my testimony. In those decisions, the courts found that a fair return should meet the following criteria: (1) return commensurate with the return on another investment of comparable risk, (2) return sufficient to maintain the financial integrity and the utility's access to capital, and (3) a return which will maintain the credit quality of the utility.

Toward these objectives, Mr. Moul's proposal for limiting companies to only the geographical area around the subject company would be inappropriate for several reasons. First, utility companies compete on a national basis for investor capital. Consequently, IP and other Illinois utilities will be competing with utility companies and competitive companies in neighboring states, and across the U.S. for investors' capital. Therefore, it is reasonable to develop a comparable group of utilities across the country to estimate a fair common equity return because IP is competing with other companies on a national basis for investor capital. A competitive return is needed to preserve IP's ability to attract capital.

Second, limiting the universe of comparable risk companies may limit the accuracy of the estimate for a fair rate of return for IP. Using unreasonable constraints that limit the accuracy of the return on equity estimates benefits neither the customer nor shareholders, and may also fail the competitive return standard.

Q IS MR. MOUL'S CONTENTION THAT YOU SHOULD HAVE USED MORE THAN ONE PROXY GROUP REASONABLE?

A No. Mr. Moul stated this as an opinion and provided no backup to support his contention. His statement is simply that "failure to employ a second proxy group substantially diminishes the value of his recommendation." (IPC Ex. 4.12, page 11). Mr. Moul's contention here is totally unsupported and unreasonable.

My proxy group was selected based on the risk parameters I identified in my direct testimony. Those risk parameters produced a reasonable proxy group that can be used to estimate IP's return on common equity. Mr. Moul's argument here is wholly unsupported and without merit and should therefore be rejected.

Q IS MR. MOUL'S CONTENTION THAT YOUR PROXY GROUP HAS LESS RISK THAN IP BECAUSE ITS COMMON EQUITY RATIO IS HIGHER THAN THAT OF IP'S REASONABLE?

A No. At page 11 of his rebuttal testimony, Mr. Moul compares IP's common equity ratio, 36%-37%, to the average common equity ratio published by Value Line of my comparable group, 45.8%, and concludes that my comparable group has less financial risk than IP because its equity ratio is higher. Mr. Moul's analysis is, however, flawed and must be rejected. A proper comparison shows that my group's equity ratio is comparable to IP's ratemaking capital structure.

The Value Line common equity ratios used by Mr. Moul are based on capital structures that do not include short-term debt in the amount of total debt or total capital. However, IP's capital structure in this proceeding does include short-term debt. The common equity ratio for my comparable group is 38% when short-term debt is included as total debt and in total capital, which is comparable to IP's capital structure in this proceeding. This common equity ratio is shown on my direct testimony IIEC Exhibit 2, Schedule 1 under column 5, and is published by C.A. Turner. Hence, my group's common equity ratio of 38% compares very well to IP's common equity ratio of 36%-37% as estimated by Mr. Moul.

Q PLEASE SUMMARIZE MR. MOUL'S ARGUMENTS CONCERNING YOUR DCF ANALYSIS.

A Mr. Moul's arguments are: (1) a 6-month average stock price is more appropriate than a 13-week average stock price as I used, (2) I should have used more than one growth rate estimate, and (3) DCF results should have been adjusted upwards for IP's higher risk.

Q IS MR. MOUL'S CONTENTION CORRECT THAT THE DCF ANALYSIS BASED ON A SIX-MONTH AVERAGE PRICE RATHER THAN A 13-WEEK AVERAGE PRICE PRODUCES MORE RELIABLE RESULTS?

A No. Selecting a period over which to measure the dividend yield in a DCF model deals with attempting to minimize the risk of poorly estimating the yield due to market price volatility and relying on a yield derived from a stock price that does not reflect the security's long-term value. I would agree with Mr. Moul that a spot price is more susceptible to temporary market volatility than is an average price. In selecting an appropriate average price, one must weight the concerns of using historical data which no longer reflects current market expectations with using an aberrant price that does not reflect the security's long-term value. In my DCF analyses, I have used 13-week average prices to limit the data to recent market valuations of utility securities, while minimizing the risk of relying on volatile, potentially aberrant, spot prices that do not reflect long-term value. The 13-week average price is superior to a six-month average price because it better reflects current investor expectations while minimizing short-term price fluctuations. Therefore, I recommend the Commission reject Mr. Moul's proposal for a six-month average price and rely on a 13-week average price.

Q IS MR. MOUL'S CONTENTION CORRECT THAT A DCF ANALYSIS WOULD PRODUCE A MORE RELIABLE RESULT IF MORE THAN ONE CONSENSUS GROWTH RATE ESTIMATE IS USED?

A No. Only IBES and First Call published growth rates for all the companies included in my comparable group. As shown below in Table 1, the projected IBES growth rates and First Call growth rates produce nearly the exact same group average growth rates. Therefore, my DCF analysis would not have changed if I had used First Call instead of IBES. Again, neither Zacks nor Market Guide published growth rates for all the companies included in my group, therefore, I could not have completed my DCF analysis with these sources.

TABLE 1

Consensus Energy Growth Projection

Line	Utility	IBES (1)	First Call (2)
1	Empire District Electric Company	6.00%	6.00%
2	Entergy Corporation	9.27%	9.42%
3	IDACORP, Inc.	7.50%	7.50%
4	Kansas City Power & Light Company	5.67%	5.67%
5	NSTAR	6.80%	6.67%
6	Pinnacle West Capital Corporation	7.80%	7.91%
7	Potomac Electric Power Company	4.69%	4.69%
8	Progress Energy, Inc.	6.79%	6.79%
9	**Average**	**6.82%**	**6.83%**

Q IS MR. MOUL'S CONTENTION THAT YOUR DCF BE ADJUSTED UPWARD TO REFLECT IP'S HIGHER RISK REASONABLE?

A No. This argument is based on Mr. Moul's flawed comparison of IP's common equity ratio, including short-term debt, to the common equity ratio of my group, excluding short-term debt. As discussed above, an accurate comparison shows that IP's common equity ratio is similar to my comparable group. Therefore, Mr. Moul's proposed risk adjustment is flawed and should be rejected.

Q PLEASE SUMMARIZE MR. MOUL'S REBUTTAL TO YOUR NON-CONSTANT GROWTH DCF ANALYSIS.

A Mr. Moul contends that my non-constant growth DCF analysis was performed because I didn't like the results of my constant growth model. He further argues that the reasons I have laid out for considering a non-constant growth model are not compelling. Mr. Moul contends that a utility's growth rate can exceed the nominal growth rate to the U.S.

economy indefinitely due to productivity enhancements. Therefore, the non-constant growth model should be rejected. Finally, he references FERC standards for establishing when a non-constant growth model should be used. He finds that based on the FERC standards, a non-constant growth model is not necessary in this proceeding.

Q PLEASE RESPOND TO MR. MOUL'S CONTENTION THAT YOUR REASONS FOR CONSIDERING A NON-CONSTANT GROWTH MODEL IN THIS PROCEEDING ARE NOT COMPELLING.

A The purpose for my non-constant growth model was to capture the possibility that a consensus of investors do not believe that the five-year IBES growth projections will be able to remain in effect indefinitely as required by the constant growth model. Hence, a two-stage growth DCF model is an attempt to broaden by DCF estimates to capture rational investor expectations. The reason I believe a two-stage model was needed in this case is because the short-term IBES growth rate projections currently are higher than earnings growth rate projections for electric utilities in the past and, more importantly, exceed the projections for the nominal growth to the U.S. economy. If investors are rational, one would not reasonably expect a utility's growth rate could exceed the nominal growth rate to the economy into which it sells its goods and services. Mr. Moul's contention that I performed a two-stage model only because I didn't like the results of my single-stage DCF model disguises his failure to explain why this model is unreasonable.

Mr. Moul's contention that productivity enhancements can explain why electric utility growth rates can exceed the nominal growth rate to the U.S. economy defies industry projections and the mathematical support for the constant growth DCF model.

Mr. Moul states that the GDP growth may represent a plausible growth rate in revenues over the long run for utilities, but contends it is not the same as a growth rate in earnings. However, I contend that it would be implausible to expect that earnings could grow at a rate substantially higher than revenues over an indefinite period of time for several reasons. First, if earnings grew faster than revenues, the Company's net profit margin (i.e., earnings divided by revenues) would be increasing over time. Analysts are, however, not projecting an increase to electric utilities net profit margins. The past and projected net profit margin for utilities is shown below in Table 2 as reported in Value Line. As shown in Table 2, utilities' net profit margins as projected by Value Line have not been increasing and are not projected to increase. Therefore, industry projections contradict Mr. Moul's opinion that earnings will grow faster than revenues.

TABLE 2

Utility Net Profit Margin

	Actual			Projected
	1997	1999	2000	2003-2004
Revenue (Billions)	208.2	291.5	401.7	650.0
Net Profit (Billions)	16.6	20.0	13.0	28.0
Net Profit Margin	8.0%	6.9%	3.2%	4.3%

Source: The Value Line Investment Survey October 5, 2001 at 695

Second, Mr. Moul's contention that revenues will grow slower indefinitely than earnings is inconsistent with the mathematical constructs of the constant growth DCF model. The DCF model assumes a constant growth in earnings, dividends, price/earnings ratio, stock price, and by default revenues.

Finally, utility regulated earnings entitlements are set based on allowing a fair return on utility plant investment that is in turn used to develop a utility's revenue requirement. Utility earnings growth could only exceed revenue growth indefinitely if earnings become an increasingly large percentage of a utility's revenue requirement. This would require either a constantly increasing rate of return on utility plant (or rate base) over time or the eventual elimination of utility operating expenses. Neither of these possibilities is a reasonable expectation.

Q PLEASE RESPOND TO MR. MOUL'S CONTENTION THAT USING THE FERC STANDARDS, NON-CONSTANT GROWTH MODELS SHOULD NOT HAVE BEEN USED IN THIS PROCEEDING.

A I have not verified Mr. Moul's contention of his assessment of the FERC standards. However, he claims they are:

1) A dividend payout ratio analysis;
2) Assessment of restructuring; and
3) Whether analysts growth estimates are two to three times greater than GDP growth.

As discussed below, two of these three tests are met. The third test, I believe, is too restrictive.

Q WOULD ADOPTION OF A FERC DIVIDEND PAYOUT RATIO ASSESSMENT CRITERION SHOW THAT A NON-CONSTANT GROWTH MODEL SHOULD BE USED IN THIS PROCEEDING?

A Yes. As Mr. Moul showed at page 13 of his direct testimony, using my comparable group, the dividends as a percentage of earnings or payout ratio are declining over the period 2001 through the projected next three to five-year period. A declining dividend payout ratio means that earnings are growing at a faster rate than dividends. Earnings growth rates are a proxy for dividend growth rates in the DCF model. Hence, if dividend growth is held constant or at a minimal level in order to reduce the payout ratio, earnings growth will accelerate as the payout ratio is declining. However, once targeted payout ratios are achieved, earnings growth rates will decline and dividend growth rates will increase to a more sustainable and constant level. Hence, Mr. Moul's declining payoff ratio evidence is an excellent reason to consider a non-constant DCF growth model in this proceeding.

Q DO YOU BELIEVE THAT A NON-CONSTANT GROWTH MODEL IS APPROPRIATE GIVEN THE CURRENT CHANGES TO THE ELECTRIC UTILITY INDUSTRY?

A Yes. Industry changes were one of the two primary reasons I referenced in my direct testimony for considering non-constant growth model. That is, I observed that companies in the electric utility industry today have merchant generation and wholesale power trading activities. Power markets currently are in a state of transition, and have resulted in significant volatility in wholesale power prices. As a result, utility earnings projections over the next three to five years are, in my opinion, impacted by the significantly increased profit potential of merchant generation and wholesale power trading affiliates.

Q ARE ANALYSTS' GROWTH RATES TWO TO THREE TIMES THE GROWTH TO THE GDP PER MR. MOUL'S REQUIREMENTS ?

A No. However, I do not believe this is a reasonable standard. The described standards will only determine when a non-constant growth model should be used when earnings growth projections are too high. I have used non-constant growth DCF models in the last ten years when I found that earnings growth rates used in a constant growth DCF model were too low and produced unreasonably low DCF results. Hence, the selection process should work symmetrically when five-year growth rates are either too high or too low to represent long-term sustainable growth rates.

Further, I see no value in limiting the use of a non-constant growth model to only when analysts' growth rates are significantly higher than the GDP growth. The closer analysts' growth rate projections are to the GDP growth projections, the less of a difference there will be in a two-stage DCF model and constant growth DCF model. As a result, I believe the weight of the two-stage DCF model should be placed on the difference between the results of a constant growth DCF model and other market-based models.

Q PLEASE SUMMARIZE MR. MOUL'S CRITICISMS OF YOUR RISK PREMIUM ANALYSIS IN THIS PROCEEDING.

A Mr. Moul takes issue with my risk premium for the following reasons:

1. He says a 15-year study period is arbitrary;
2. He believes it is inconsistent to estimate an equity risk premium using Commission-authorized returns to contemporary utility bond yields. He believes these returns are not comparable, and he is also concerned that the two returns are not time synchronized;
3. He argues that this methodology is circular; and
4. Finally, he is concerned that old risk premiums may not reflect the new risk of the industries.

Q PLEASE RESPOND TO MR. MOUL'S ARGUMENTS.

A Mr. Moul's contention that a 15-year study period is arbitrary is without merit. The 15-year study period was chosen based on the amount of available data I had to construct this analysis, and is also an appropriate time period because it reflects a period where utility stock valuations are similar to current valuations. As shown on my IIEC Exhibit 5, Schedule 2, over the last 15 years electric utilities' stock market price to book value ratios have been in excess of 100%. In the late 1970's and early 1980's, electric utilities' market price to book value ratios were less than 100%. Hence, this 15-year study period includes Commission-authorized returns that helped to support utility stock price premiums to book value which are reflective of current market utility stock valuations.

Mr. Moul's contention that Commission-authorized returns are inconsistent with contemporary utility bond yields is unfounded. Commission-authorized returns are typically based on expert witnesses' estimates of the current investor required return or cost of common equity for the subject utility. A bond yield is the current market observable cost of debt. The two return requirements are comparable and both represent the current market cost of capital for the two different securities. Therefore, the Commission-authorized returns in relationship to a contemporary Treasury bond yield provides a reasonable measure of the utility equity risk premium over Treasury bond yields.

Mr. Moul also opines that the Commission-authorized return to the contemporary utility bond yield may not be perfectly synchronized. I agree that it may not be possible to perfectly synchronize the contemporary bond yield with the time period for which the analysis was constructed that led to the Commission determined authorized return. Nevertheless, like the DCF and CAPM[1] that Mr. Moul uses, this model may not be perfect and it does reflect simplifying assumptions, but I believe it is a model that reasonably establishes risk premium that helps measure the cost of common equity.

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[1] The DCF and CAPM reflect simplifying assumptions also including assumptions related to income tax rates and simple linear trending projections.

Mr. Moul's argument that this model is circular is also without merit. Commission-authorized returns are typically based on estimates of a utility's cost of common equity capital. These are estimates of the market required returns, not previously approved regulatory authorized returns. The model is not circular.

His final concern is that risk premiums measured over historical periods may not reflect the new risk of the electric utility industry going forward. While it is true that the risk of the industry may change going forward relative to the past, it is not unreasonable to continue to use this model. Further, Mr. Moul's own risk premium analysis is based on the achieved return of utility stocks relative to public utility bonds over the period 1928 through 2000. Mr. Moul argument here contradicts his own historical equity risk premium analysis.

Q PLEASE SUMMARIZE MR. MOUL'S RESPONSE TO YOUR CAPM ANALYSIS.

A Mr. Moul takes issue with my CAPM analysis based on primarily two factors:

1. He believes it would be appropriate to include a size adjustment to the results of my CAPM analysis; and
2. He believes that my market risk premium used in my analysis was downwardly biased because the implied projected return on the market is lower than that reflected or estimated by Staff.

Q PLEASE RESPOND TO MR. MOUL'S CONTENTION THAT A SIZE ADJUSTMENT SHOULD BE MADE TO YOUR CAPM ANALYSIS.

A Mr. Moul's proposed size adjustment to the results of a CAPM analysis should be rejected for several reasons. First, the size adjustment is based on Ibbotson & Associates size decile portfolio analysis as contained in the 2001 Yearbook. Ibbotson derives this size adjustment based on a portfolio of mid-cap and small-cap companies that exhibit more risk than the overall market (i.e., they have a beta greater than one). In significant contrast, the companies in my comparable group have betas significantly lower than one. Hence, the beta risk of the companies included in the Ibbotson mid-cap and small-cap studies are not remotely comparable to the risk of the electric utilities included in my comparable group. Therefore, the Ibbotson size adjustment is totally inappropriate for my comparable group and for IP.

Second, the mid-cap and small-cap companies included in the Ibbotson studies are competitive companies that do not enjoy the protection of monopolistic service areas, and regulatory price protection. Further, it isn't clear whether or not these companies have investment grade bond ratings, are followed by the Value Line Investment Survey, or have any reasonable comparable attributes to electric utilities in general, or the comparable groups upon which my CAPM return is estimated. Therefore, the size adjustment is in no way appropriate for an electric utility company in general or for IP, in particular, because it is not based on similar risk companies.

Q PLEASE RESPOND TO MR. MOUL'S CONTENTION THAT THE MARKET RISK PREMIUM USED IN YOUR CAPM WAS UNDERSTATED.

A Mr. Moul's contention in this regard is unfounded. He bases his argument on his and Staff's projected market returns which are used in the CAPM to estimate the market risk premium. As described below, Mr. Moul's market return estimate should be rejected and Staff's market return estimate should be considered at the high-end of reasonableness. Neither market return estimate supports Mr. Moul's statement that my estimate of the market return is too low.

Mr. Moul's market return estimate is 19.51% and is based on a terminal value DCF model. The DCF model was based on a projected growth rate of 17.41% and a dividend yield of 2.1%. The growth rate included in Mr. Moul's market DCF model is unreasonably high for a constant growth DCF model and does not meet Mr. Moul's own standard to consider a non-constant growth DCF model. Mr. Moul cites one FERC standard for considering a non-constant growth DCF model when the growth rate employed in the DCF model is two to three times the growth rate of the U.S. GDP. Mr. Moul's projected market growth rate of 17.41% is more than three times the projected nominal growth of the U.S. economy of 5.5%. Clearly, the growth rate in Mr. Moul's constant growth DCF return is excessive and, therefore, his DCF return is excessive.

The growth rate implicit in Staff's 15.31% market return is approximately 13.3% which is also extremely high. The current dividend yield on the S&P 500 is approximately 2%, which implies a projected growth on the S&P 500 of approximately 13% (15.3% less 2%). The growth rate implicit in Staff's DCF return on the market is between two and three times the projected growth rate to the U.S. GDP. Hence, Staff's constant growth market DCF analysis is based on an extremely high growth estimate that is unlikely to be sustainable over an indefinite period of time.

Finally, Mr. Moul concludes that the market risk premium in my CAPM implies a market return of between 12.4% to 13.2%. With a market dividend yield of approximately 2%, this implies a growth rate of between 10.4% and 11.2%. These market growth rates are approximately two times higher than the projected 5.5% growth to the U.S. GDP. While this growth projection is not nearly as high as Staff's, it is certainly more reasonable than the growth rate used in Mr. Moul's market return estimate. For this reason, the market risk premium used in my CAPM is not unreasonably low as Mr. Moul implies.

Q DID MR. MOUL PROVIDE A RESPONSE TO YOUR DESCRIPTION OF SECURITY ANALYSTS' AND UTILITY EXECUTIVES' POSITIONS CONCERNING THE CHANGE IN RISK FOR A DISTRIBUTION UTILITY COMPARED TO AN INTEGRATED UTILITY OR GENERATION UTILITY ONLY?

A Yes, he disagreed with me that transmission and distribution services have low risk, but admitted that these services "may have lower risk than other segments of the electric utility industry sector, but they are not low risk endeavors." (IP Exhibit 4.12, Page 21).

Q IS IT YOUR POSITION THAT A TRANSMISSION AND DISTRIBUTION COMPANY IS A RISK-FREE ENTERPRISE?

A No. In my direct testimony, I provided support for my belief that transmission and distribution utilities have lower risk than integrated electric and generation-only electric companies. This information is important in setting capital structure policy objectives for distribution companies because these companies can finance themselves with greater percentages of debt because their business risks are lower than integrated electric and generation-only companies. I do want to be clear that I did not testify that transmission and distribution companies do not have risk. The level of risk is important in assessing appropriate capital structures and return on common equities. However, it should be incumbent on the utilities to recognize their opportunities to lower their overall cost of capital by using capital structures that will maintain current bond ratings, preserve financial integrity, and keep rates to customers as low as possible.

Q AT PAGE 2 OF HIS REBUTTAL TESTIMONY, MR. MOUL CITES PROJECTED RETURNS ON BOOK EQUITIES FOR STAFF'S COMPARABLE GROUPS OF 14.3% AND 13.4%, AND YOUR COMPARABLE GROUP OF 11.8%, RESPECTIVELY. ARE

THESE VALUE LINE PROJECTED EARNED RETURNS ON BOOK EQUITIES A REASONABLE ESTIMATE OF AN APPROPRIATE AUTHORIZED RETURN ON COMMON EQUITY FOR IP?

A No. Estimating an authorized return on equity based on Value Line's projected earned return on book equity is a form of a comparable earnings analysis. As I discussed in my direct testimony, a comparable earnings analysis is a flawed methodology for estimating a fair rate of return. A comparable earnings analysis does not measure the investor required return, but rather simply measures the accounting return. The investor required return is the return investors demand in order to make investments. In significant contrast, the accounting return is simply the projected earned return on book equity which may or may not be an adequate return to attract investor capital.

Further, Mr. Moul performed no analysis in order to estimate the distribution of these earned returns on equities between the regulated and non-regulated business functions of the companies in the comparable groups used by Staff and myself. To the extent these companies include non-regulated operations, with little to no book investment, the earned return on book equities could significantly overstate the earnings attributable to regulated operations. Also, Mr. Moul performed no analysis to determine the contribution to the earned return on equities of the companies in the comparable groups based on the regulatory treatment of investment tax credits. The regulatory treatment of investment tax credits provides utilities an opportunity to earn a return on book equity that is higher than the authorized return on equity.

For all of these reasons, using Value Line's projected earned return on book equity as Mr. Moul implies is not a reasonable method to estimate a fair rate of return on common equity for IP's regulated operations.

RESPONSE TO ICC STAFF WITNESS ROCHELLE LANGFELDT

Q WHAT RETURN ON COMMON EQUITY HAS STAFF WITNESS ROCHELLE LANGFELDT RECOMMENDED FOR IP?

A Witness Langfeldt has recommended an 11.89% return on common equity for IP. Witness Langfeldt's return on common equity is based on two comparable groups comprised of an LDC sample and an electric utility sample. Based on witness Langfeldt's DCF and capital asset pricing models, witness Langfeldt's estimates support the proposed return on common equity for the LDC group of 11.82%, and for the electric utility sample of 11.96%. The average of the two groups supported the recommended return of 11.89%.

Q IS WITNESS LANGFELDT'S DCF ANALYSIS REASONABLE?

A Witness Langfeldt's analysis is reasonable. However, I have similar concerns about the growth rate used in her constant growth DCF analysis that are similar to the concerns I express about my own constant growth DCF analysis. As I did, Ms. Langfeldt used consensus analysts' earnings growth projections as the sustainable growth rate in the DCF analysis. The average growth rate for witness Langfeldt's electric sample was 7.08% and the LDC sample was 7.17%. These growth rates are both considerably higher than the projected growth rate of the U. S. economy of 5.6% that I referenced in my direct testimony. The growth rate of the U.S. economy is a reasonable benchmark for a sustainable return. Since the growth rates supporting Staff's DCF return are clearly higher than a sustainable long-term growth rate, witness Langfeldt's constant growth DCF results are upwardly biased. In my judgment, witness Langfeldt should have at least tested the results of the DCF analysis by considering a non-constant growth model in this proceeding.

Q DO YOU HAVE ANY CONCERNS RELATED TO WITNESS LANGFELDT'S CAPM MODEL?

A Yes. Witness Langfeldt's CAPM model was relied on a risk premium estimate, which was derived from the DCF return on the market of 15.31% less the estimate of risk-free rate of 5.48%. Witness Langfeldt's projected return on the market of 15.3% was based on a bottom-up DCF return to improve this estimate on the individual companies included in the S&P 500 index. While I believe this is one reasonable method for estimating the projected return on the market, I note that there are other credible and reasonable methods that produce equally reliable and accurate projected returns on the market. The weakness in witness Langfeldt's CAPM analysis is that only one projected return on the market was relied upon. An estimate of the projected return on the market is no more straightforward or reliable than estimating the projected return for an electric utility. Staff uses various methods to estimate IP's investor required return in this proceeding. Presumably, Staff used more than one method to improve the accuracy of its cost of equity estimate for IP. Staff should have also used more than one method to estimate the expected return on the market in its CAPM analysis.

Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A Yes.

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